Audit's
MONTHLY NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS

# Realty Trust Review

Monday, December 13, 1971 VOL. II, NO. 17

TRUST SHARES FOR YOUR ATTENTION



INDUSTRY TRENDS



## TRUSTS FACE TOUGHER FINANCING

Banks are going to take a harder look at lines they have extended to trusts. This is a result of being frightened by Continental Mortgage questioning "relaxed underwriting standards" for real estate loans by some trusts. The degree of relaxation aside, and there has undoubtedly been some within the industry, the fact that prominent public attention has been called to trust loans seems to be making banks generally wary. The public markets have also become a more difficult financing route. The SEC is now making more intensive reviews of new trust issues and requiring managers to comment as to how Continental Mortgage's criticism will affect them. New trust underwritings have since been rougher. NJB Prime was nearly throttled, arriving at $20 (it sold for $19 this week) while Gulf South Mortgage, has seen its $20 unit dip to $18 with the stock selling for $15. Builders Investment Group, a hot equity registrant not too long ago, barely eked out on December 7 and drifted to a small discount. With two major financing sources now being constricted, sponsorship is no longer a cliche.

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## MARGIN BUYING OF SHORT-TERM REIT SHARES SUGGESTED AT THIS MARKET JUNCTURE

Events of the past three weeks have combined to make margin buying of realty trust shares something which should be considered by sophisticated investors. An unusual juxtaposition of interest rates combined with the lowering of margin requirements by the Federal Reserve Board last week set up the unusual situation. However, there are risks which investors who have never bought on margin should understand thoroughly before opening a margin account.

To recap, the market flap over *Continental Morgage Investors'* public announcement that it expected lower earnings over the next two quarters (RTR, Nov. 29) drove prices of most REITs down by about 14%. While shares have since recovered by about 6% from the panic lows, the break in REITs increased yields by about ½%-1% for the short-term mortgage trusts and by about ½% for long-term mortgage trusts and for equity trusts. As shown by our latest pricing, the average yield on short-term mortgage trusts estimated from latest dividend declarations was 8.75%, ranging from highs of 10.8% and 10.7% for National Mortgage Fund and Associated Mortgage Investors, respectively, to a low of 5.5% for Hamilton Investors, a new trust just making its first quarterly declaration.

Then last week the Federal Reserve Board cut the required margin, or down payment, for stock purchases from 65% to 55%. The cut applies to about 500 OTC stocks in addition to NYSE and ASE listed issues. The margin reduction in effect is the FRB's invitation for individual investors to buy stocks. In the past it has generally been to the investor's advantage to take advantage of these offers.

Finally, short-term interest rates have been soggy, with the basic prime lending rate for commercial banks at 5½% and some speculation that it may move lower. When an individual investor borrows from his broker to buy stocks on margin, he usually pays from ½% to 1% over prime, so the bulk of margin accounts would carry interest rates in this range.

This series of events enables the individual investor to leverage his investments in exactly the same way a realty trust seeks leverage. He can thus borrow from his broker and buy REIT shares that are paying on average 2% to 2½% higher dividend than his cost of borrowing.

Margin stock buyers generally look for situations where the stock "lends flat" --i.e., the dividend or interest income covers the broker's interest charges on the money borrowed. This lets the investor go after higher capital gains with no out-of-pocket costs.

On the other hand, margin buying is undesirable if prices of the stocks held do not go up and downright unpleasant if stock prices decline sharply. If they fall to the maintenance margin level--generally to the value of the margin loan--the investor can be required to put up additional cash--a margin call--or have the shares sold at market prices to satisfy the loan. There is no fixed margin maintenance level by brokers; it varies with the broker and the account. As a general rule, though, it ranges around 40-50%. So this is not an investment mode for everyone.

One further caution: margined securities must be held in your broker's name, so if you have any doubts about the back-office capability or solvency of your broker, don't buy on margin.

On balance, we believe the risk/reward ratio is heavily in the investors favor. With trust shares well down from market highs and holding firm, we rate the risk of

further serious price erosion for most quality issues to be low. On the other hand, upside potential for many trust issues is now the highest in months, if one is not in too much of a hurry.

With these caveats, here is how a margin purchases of REIT shares could work. Assume that you have $10,000 cash, or hold REIT shares with $10,000 market value at present. Under the new lower margin rules, you can borrow up to $8,200 to purchase additional shares. In the example below, we have assumed that your purchasing power will allow you to buy $17,835 of shares and absorb $365 in commissions. Your portfolio will then look like this:

| | |
|---|---|
| Market value of holdings | $17,835 |
| Estimated annual dividends at 8.5% | 1,510 |
| Less: Cost of $8,200 margin loan at 6¼% | 533 |
| Net portfolio income to you | $ 977 |

Over a year, then, your dividend income is increased by about 1¼% to about 9 3/4% by this maneuver.

The risk obviously is whether Continental Mortgage Investors' spokeman was correct in forecasting widespread earnings declines for short-term mortgage trusts. Little noticed in the furor was the fact that many smaller trusts have already experienced earnings declines, the list running to *Associated Mortgage Investors*, *Galbreath Mortgage Investors* and many others. And we pointed out that many trusts have already absorbed portfolio yield declines of 1½%-2% or more with little or no damage to earnings.

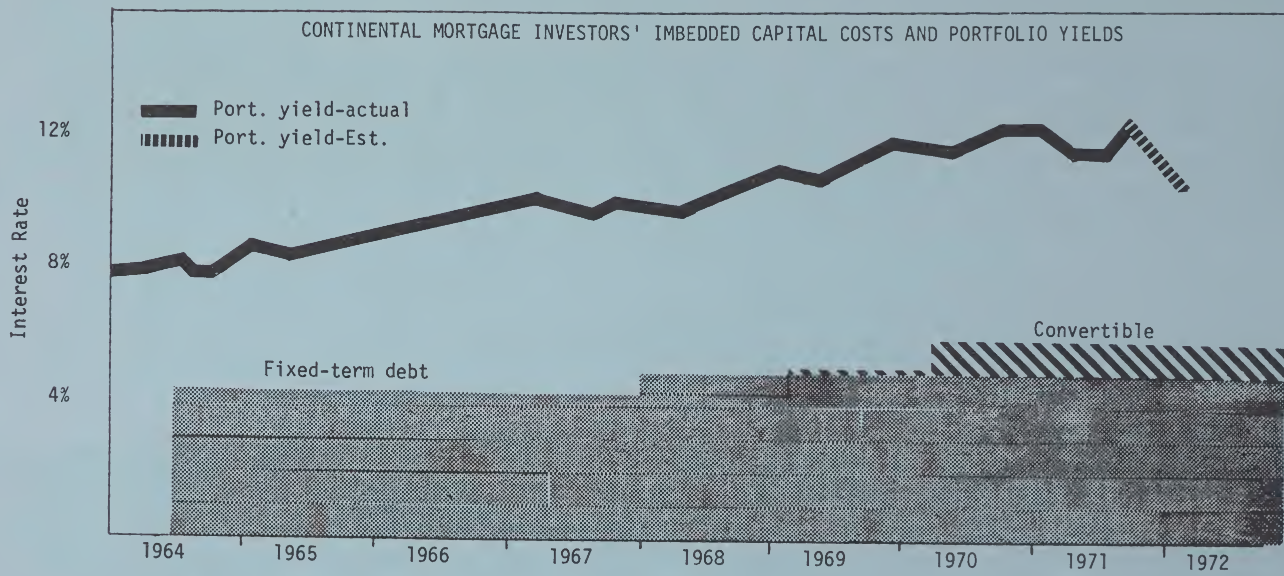
Finally, we point out in the article below again that there are very special reasons why Continental Mortgage was peculiarly and almost uniquely vulnerable to the "double whammy" of declining portfolio yield and declining portfolio.

We are so convinced of the correctness of our recommendation for margin buying at this particular market juncture that we are purchasing additional shares of selected trusts in our Model II Intermediate-Term, Aggressive portfolio. These changes are detailed on page 7, and generally follow our suggestions of last issue. Our present intention is to hold these shares at least six months but conditions may dictate a shorter holding. We are cognizant of the fact that some subscribers may be critical of our stance as either too risky or overly oriented to short-term trading. But as we have frequently remarked, short-term trust shares should generally be considered as short to intermediate-term vehicles since their earnings can be predicted only about four quarters ahead with confidence. And you expect our unhedged recommendations regarding investment policy. In this situation we can do no less than shape our model portfolio to these directions.

## WHY CONTINENTAL MORTGAGE IS VULNERABLE TO A 'DOUBLE WHAMMY'

Some subscribers have interpreted our comments of last issue as blaming leverage entirely for the widely advertised coming break in Continental Mortgage Investors' incredible string of 38 quarters of ever-rising earnings comparisons. The culprit however was a very special kind of leverage, one almost unique among short-term mortgage trusts.

That was Continental's decision in the mid-1960s to begin borrowing long. This flew in the face of conventional investment wisdom, which generally dictates that borrowing and lending maturities should be matched. But Continental borrowed long while it continued to lend short.




For over six years the gamble paid off. Continental's low average 5.01% cost of long-term money was the envy of all the short-term mortgage trusts which sprang into being in 1969 and 1970 and had difficulty borrowing. Short-term funds were expensive when they could be obtained and long-term borrowing was virtually out for all but Continental and the other older short-term trust, First Mortgage Investors.

The chart traces CMI's borrowing practices, starting with placement of $11 million of 4½% notes in May, 1964; $13.32 million of 5½% notes in December, 1965, and $28.0 million of 5½% notes in December, 1967. The two early placements were made at the then-prevailing prime rate and with these placements CMI sold 1,998,000 shares at prices of $2.52 and $5.35 per share (all numbers adjusted). This gave CMI its major base of $52.3 million fixed debt with an average cost of 5.01%, all locked in for 15 and 20 years, as shown on the chart.

Then in February, 1969 Continental placed $80.0 million of 5% convertible debentures with private investors and followed a year later with public sale of an additional $85 million. This marked CMI's first venture into the world of convertibles and even with this equity sweetener, the interest rate on the second convertible issue moved up to 6¼%. These convertibles form the second layer of capital on our graph.

Even though some of these debentures have now been converted into shares, the total of $149 million of fixed-rate capital--or 34.8% of total assets at Sept. 30--constituted the proverbial immovable object.

It is a massive imbedded cost of capital which can not be changed. Public utilities, for instance, operate with capital structures quite similar to CMI but can survive because their rates and charges are generally tied to this cost of long-term capital, although there may often be a lag in approval of rate increases by regulatory bodies.

But CMI's interest charges are not fixed by utility commissions; they are governed by money market forces and when portfolio yield began falling, yields fell directly

down to that imbedded capital cost. There was no way the trust could bring its money costs down on this portion of capital.

Contrast this with the experience of other highly leveraged short-term trusts like Continental Illinois Realty (cited last issue) and Citizens & Southern Realty. Both are leveraged more highly than CMI but entirely with commercial paper and other short-term debt. When portfolio yields dropped, so too did their entire cost of money. Their money costs have now dropped 1% or more below CMI's major block of long-term money.

CMI, also in the commercial paper market, can of course reduce its interest on short-term borrowings the same way. But since its short-term debt is only about half of its total borrowings, the reduction is much less effective. Couple this with declining portfolio--i.e., the trust will wind up with fewer earning assets --and you have the decline heard round the market world.

In the current market environment, investors and the banks which provide short-term loans to short-term trusts should understand clearly that CMI's earnings decline was almost pre-ordained when the trust began borrowing long and lending short. The money markets had to catch up with that strategy sooner or later. This reason was not given perspective when poorer profit conditions were attributed largely to competitors. Investors should not lose sight of individuality and selectivity because of such generalizations.

## CONFUSION OVER PRIMARY AND DILUTED EARNINGS, ATICO EXAMINED

The problem of selecting the most meaningful earnings number is becoming most difficult as more trusts issue both convertibles and warrants. Trusts with such capitalizations provide three numbers and investors have to sort out which is most indicative of earning power. Reported are primary earnings, diluted earnings after allowing for warrants exercise and dividends. Earnings just after debenture conversion alone are not reported. If we may make a public call for such calculations, the investing public would then have the most valid earnings number. The logic for diluted earnings based on conversions is long known and expounded by Ben Graham many years ago in his standard text on security analysis. The funds from converts are already employed by the company or trust and the shares should be treated as issued since they are contingently issuable. The earnings calculated after warrant exercise are another story for analytical purposes. Those funds are not presently employed and earnings as calculated by the trusts under Accounting Principles Board Opinion No. 15, assume certain use of the warrant funds to be received, repayment of debt. Since this assumption may not prove valid over a long period, we do not consider this calculation the most useful for measuring current earning power. It is generally valuable, however, for investors just to be aware of earnings dilution in issues accompanied by warrants.

If trusts do not start publishing diluted earnings after conversions only, what are investors to do? Presently, the gap between primary and diluted earnings for those with large warrant issues is so wide as to be bewildering. Earnings diluted for conversion can be computed after the interim report is made available with a balance sheet. The amount of convertible debentures is then known and can be converted into shares and their interest figured. The adjusted earnings are then divided by the converted shares. This, however, requires waiting for the formal interim report to be published. In the meantime, the best use must be made of immediately available data. The number most indicative of true earning power is dividends if pay out is close to 100%. Dividends are paid on the shares outstanding at the end of the period.

The problem has proliferated as more trusts have created large warrant issues in capitalizations also having convertibles. This has caused many trusts to show wide gaps in reporting per share income. Confusion has arisen over reported results by several such trusts, among them *Atico Mortgage Investors* (22 5/8-ASE). For the quarter ended October 31, 1971, Atico reported primary earnings of $0.68 per share, fully diluted profits of $0.44 while declaring a $0.55 dividend. Interestingly, we have computed converted earnings, based on preliminary balance sheet data, equal to $0.57 a share. This works out to slightly more than the dividend because the payout was a bit less than earnings. This reinforces our main contention that investors are going to have to look at dividends of trusts that report in this fashion for the quickest, most realistic indication of true earning power.

Beyond clarifying the October quarter's earnings, Atico Mortgage is one of the better situated and more attractive short-term trusts. The adviser is a subsidiary of Florida-based Atico Financial, which through a subsidiary owns a Florida-based 35 year old mortgage banker servicing over $300 million in loans and through a 21% owned bank holding company owns four banks. Most important, these organizations and the parent company have long been active in construction lending with long contacts.

It is therefore not surprising that the trust has found the wherewithal to achieve strong, continued quarter-to-quarter growth. In the latest quarter (October) fully diluted earnings were $0.44 per share compared with $0.40 in the July quarter and a $0.55 dividend was paid against $0.50. Very immpressive portfolio growth brought this about as the trust's investments climbed to $61.8 million at the end of the quarter from $44.4 million only three months earlier. Moreover, the trust has $70 million in unfunded commitments assuring growth for at least several more quarters. The trust is getting 4-5% over the prime rate on all its loans and more important feels quality has not been reduced.

The key to its originating success are old standing relationships in southern Florida where the adviser and associates have long been active. This area accounted for 70% of the portfolio and northern Florida was also significant. These regional ties with the ability to sell service have meant repeat business from many established developers at good rates. The mix between property types is well balanced and has run: 14% for land development, 21% for shopping centers, 22% for rental apartments, 26% for condominiums and 16% for intermediate term loans. The recent $61.8 million portfolio broke down by loan type in millions: $39.2 for construction loans, $10.7 for development, $2.5 for land (income producing) $4.9 for land (non-income producing) and $4.4 for junior loans.

The machinery is being set up for commercial paper with the trust now well past the minimum size. An NCO rating was applied for. The trust has its own bank lines for paper and will not need its parent's mortgage banker. The equity is still adequate for the moment as the debt/equity ratio appoached one-to-one this past quarter. To provide, however, for the coming year, additional public equity financing is being sought. A package of $25 million convertibles with more warrants was just registered. Bank lines have been used extensively to provide additional funds through leverage. Banking connections are with several major New York City and Southeastern institutions.

As a well situated regional short-term trust bred from mortgage banking and commercial banking parentage, Atico is one of the prime secondary trusts for speculative investment consideration. The current annualized yield is well above average at nearly 10%. Growth possibilities also exist. For these reasons, the shares are included in our margined portfolio on p.7.

## THE ANSWER CORNER: SUBSCRIBERS ASK ABOUT DISCOUNT BONDS, CONVERSION PREMIUMS

Q. Have you ever mentioned discount REIT bonds which may be used at par with warrants?

A. The Guardian debentures were mentioned in the Sept. 13 AR. Barnett subsequently offered a similar issue. We pointed out the debentures and warrants would trade as a package. Do not be fooled by the bond discount. The warrant premium makes up for it.

Q. Why do you not provide a column with conversion values and premiums in the debenture table?

A. Once trust debentures rise from par, the yield falls significantly below the shares which are high yielding instruments. The debentures then have no advantages over the shares, except preferential treatment of interest and liquidation which are academic in a healthy trust. They then trade at virtual conversion value with no meaningful premiums to calculate.

## MODEL PORTFOLIO REVIEW: SHORT TERM GROUP HIT HARD

The massive selling wave that engulfed short-term trusts covered the entire gamut of quality and yield. Our portfolio was no exception in the month just ended declining while the Dow Industrials rose. The proper strategy at this time is to make the most of the opportunities believed existing. The broad policy of margining positions was outlined in our lead story. More conservative investors can simply stay with a cash position. We are selling *First Mortgage Investors* at this time. FMI has heavy fixed debt costs, although less than Continental Mortgage. Additionally, the recent inclusion of a short-term property sale has somewhat clouded the operating picture.

The basis for expanding our short-term portfolio is quality and yield although not every yield is above average. We are first recommending additions of those trusts whose positions are strongest and share values were increased during the recent sell-off. *North American*, *Continental Illinois* and *Great American* yield below 8% but are exceptionally situated. *Larwin* is very sound in real estate know-how, currently yielding 8.5%, and *Associated*, yielding 9.8%, is more speculative but with the ability to improve. The five newcomers to our list contain four which have outstanding mortgaging and real estate capabilities and the fifth is a regional standout.

Being secondary to prime, national names, the recommended package of new additions yields 8.7%. *C.I. Mortgage* is a conservatively managed trust with a fine position in large income properties, only a few in New York City. Beyond internal staff, tangential ties exist with Home Insurance and the realty complex within parent City Investing. *Unionamerica's* expertise and banking connections were detailed in the October 11 RTR. *Mortgage Trust of America*, reviewed in the September 13 RTR, has in addition to its capable and aggressive staff ties with the 13th largest mortgage banker, Bankers Mortgage of California servicing $900 million, plus Occidental Insurance, all part of the Transamerica complex. *Galbreath First Mortgage's* high capabilities are belied by its recent earnings as discussed in the November 15 RTR and better things appear ahead. *Atico Mortgage Investors*, discussed this issue, p.5, is a well situated regional and a bit more speculative than the others. You will be able to sleep well while deriving above-average income from these additions. Moreover, there is a good probability of moderate appreciation over the intermediate term.

? No ?

December 13, 1971

## PORTFOLIO I
## LONG TERM, INFLATION PROTECTION

| Sh. | Issue-Ann. | Div. | Orig. price | Mkt. 12/6 | Mkt. Val. |
|---|---|---|---|---|---|
| 800 | Gen.Growth | -0.92 | $23.13 | 32.25 | 25,800 |
| 400 | US Lsg. RE | -1.60 | 22.13 | 22.25X | 8,900 |
| 700 | Penn. REIT | -0.85 | 12.50 | 12.00 | 8,400 |
| 750 | Rlty.Inc.Tr | -1.40 | 17.13 | 15.25X | 11,438 |
| 600 | Saul (B.F.) | -1.28 | 19.75 | 19.75 | 11,850 |
| 400 | Wash. REIT | -0.96 | 12.63 | 11.50 | 4,600 |
| 600 | GREIT Rlty | -1.60 | 18.25 | 17.25 | 10,350 |
| 200 | BankAm. Rlt | -1.76 | 28.75 | 25.75 | 5,150 |
| 700 | Mob.Hm.Com. | -0.30 | 9.75 | 7.50 | 5,250 |
| 300 | Cabot C&F | -1.60 | 22.00 | 27.88 | 8,364 |

Mkt. value....$100,102

| | |
|---|---|
| Cash, beginning of month | $ 5,884 |
| Dividends received | 423 |
| New purchases-none | --- |
| Cash, end of month | 6,307 |
| Net asset value, end | $106,409 |
| Net change in month | -3,024 |
| % change | -2.8% |

Dow-Jones Industrials Nov. 9 837.91

(The cash portfolio is listed separately from the margined portfolio to facilitate comparison of both).

## PORTFOLIO II
## INTERMEDIATE TERM, AGGRESSIVE

| Sh. | Issue-Ann. | Div. | Orig. price | Mkt. 12/6 | Mkt. Val. |
|---|---|---|---|---|---|
| 700 | Alison Mtg. | -2.80 | $21.00 | 27.25 | 19,075 |
| 400 | Assoc. Mtg. | -2.40 | 29.38 | 24.38 | 9,752 |
| 300 | Cont. Ill. | -2.48 | 32.12 | 32.68 | 9,789 |
| 450 | Larwin MI | -2.48 | 24.15 | 29.13X | 13,109 |
| 200 | Guard. MI | -3.28 | 33.50 | 40.25 | 8,050 |
| 300 | Grt.Amer.M | -2.22 | 26.63 | 28.75X | 8,625 |
| 200 | First Mtg. | -2.24 | 32.38 | 25.25X | 5,050 |
| 200 | No.Amer. M | -2.28 | 28.00 | 31.25 | 6,250 |
| 100 | Am. Cent. | -2.32 | 26.00 | 27.38 | 2,738 |
| 400 | Fidelity M. | -2.00 | 20.00 | 22.50X | 9,000 |
| 200 | Cameron-Br. | -2.52 | 29.50 | 31.50 | 6,300 |
| 300 | Sutro Mtg. | -1.60 | 19.38 | 20.50 | 6,150 |
| 100 | Cont. Ill. | -2.48 | 33.38 | 32.63 | 3,263 |

Mkt. value....$107,151

| | |
|---|---|
| Cash, beginning of month | $ 3,074 |
| Dividends received | 735 |
| New purchases--none | --- |
| Cash, end of month | 3,809 |
| Net asset value, end | $110,960 |
| New change in month | -10,993 |
| % change | - 9.0% |

Dec. 6 855.72 Change +2.1%

Proceeds from sale -First Mtg. $5,186
Cash now available 8,995
Additions to existing positions

| | | | | | |
|---|---|---|---|---|---|
| 200 | Grt.Amer.M | 2.22 | 28.75 | 28.75 | 5,750 |
| 200 | No.Amer.M. | 2.28 | 31.50 | 31.50 | 6,300 |
| 200 | Larwin MI | 2.48 | 29.13 | 29.13 | 5,826 |
| 100 | Assoc. Mtg. | 2.40 | 24.38 | 24.38 | 2,438 |
| | | | | | $26,840 |

New trust additions

| | | | | | |
|---|---|---|---|---|---|
| 300 | C.I. Mtg. | 2.12 | 22.75 | 22.75 | 6,825 |
| 300 | Unionamer. | 2.40 | 29.38 | 29.38 | 8,814 |
| 200 | Mtg.Tr.Am. | 2.28 | 24.63 | 24.63 | 4,926 |
| 200 | Atico MI | 2.20 | 22.63 | 22.63 | 4,526 |
| 200 | Galbreath | 2.40 | 26.63 | 26.63 | 5,326 |
| | | | | | $30,417 |

Margin required over cash position$48,262

Written as of noon, Thursday December 9.